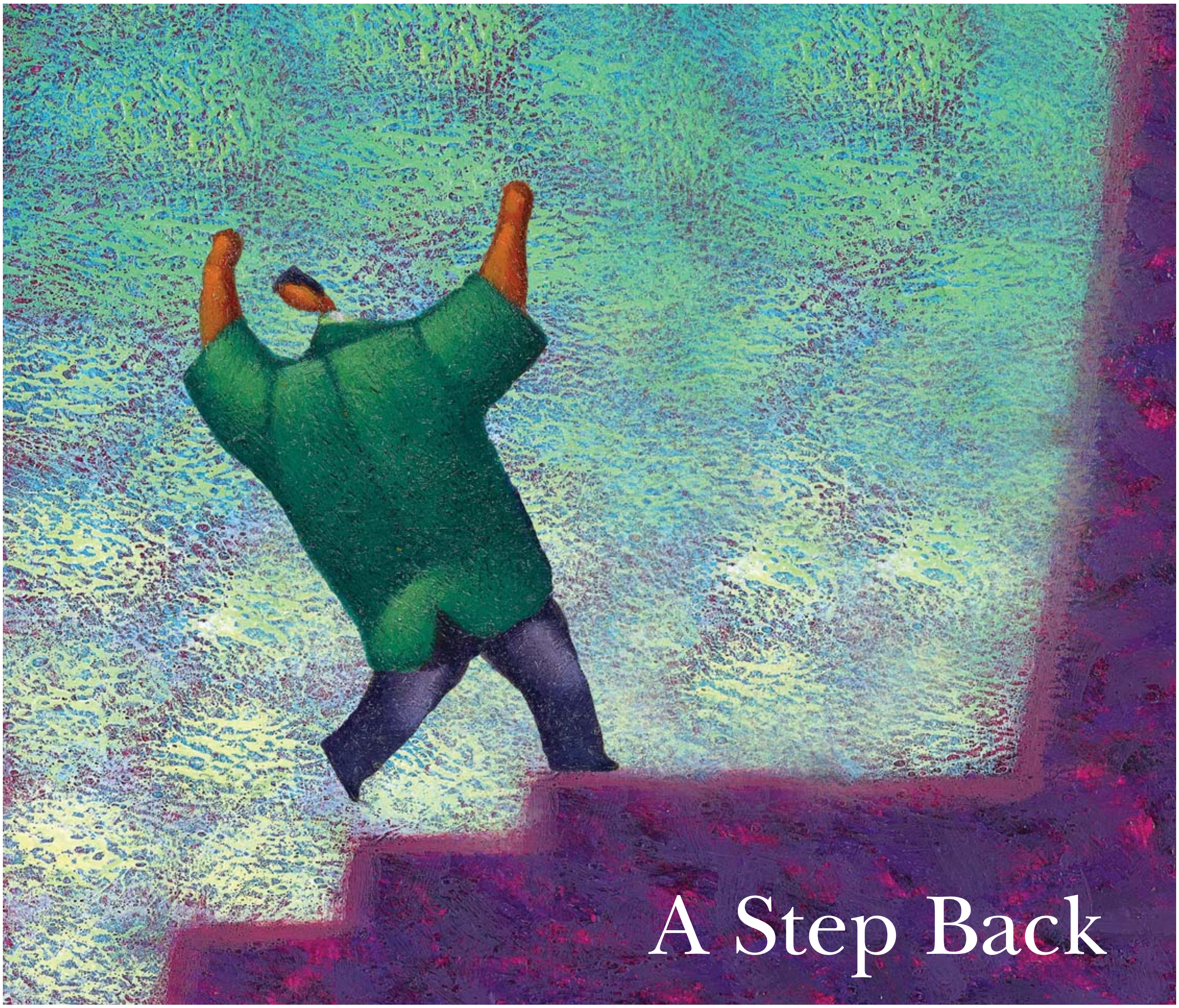
The PERAC Financial Bulletin

Financial Market Review, Second Quarter 2006

JULY 2006 | NO. 30



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After a volatile and disappointing second quarter, pension fund trustees wondered whether 2006 would be another year in which it would be very difficult to achieve their target rates of return through either traditional or alternative investments. As of mid-year, most broad stock market indices were up only slightly while rising interest rates left high-grade bonds at a modest loss for the year.

Equity Market

The equity market had been building on the first quarter's gains until mid-May, when the market turned very volatile and trended lower after new Fed Chairman Ben Bernanke surprised the market by signaling that continuing inflationary pressures might keep the central bank from relaxing its two-year old campaign of interest rate increases. Although economic growth remained at a healthy and sustainable pace and analysts were anticipating a twelfth consecutive quarter of double digit profit gains, many investors worried that further rises in interest rates would choke off the recovery.

The broad market Dow Jones Wilshire 5000 Index was down 1.91% for the quarter while still up 3.51% for the year. Large caps held up significantly better than small caps during the quarter, reflecting the general expectation that larger corporations would perform better during times of economic weakness. Nevertheless, despite falling over 5% from a record high reached in May, small caps (as measured by the Russell 2000) are still up over 8% for the year, well ahead of large caps (S&P 500) in a continuation of a six-year trend. For the trailing 5 years, small caps have outperformed large caps by an annualized 6%. As is common, the technology-laden NASDAQ Composite was particularly volatile, falling to a loss of 1.5% for the year after a 7.2% second quarter loss. Among styles, value has continued to outperform growth through the first half of 2006, continuing another long-running trend.

As always, stock performance was company specific. Surprisingly, General Motors (+40.1%) was one of the quarter's better performers as bargain hunters saw value, and some hope, in the once-great company. United Technologies (+9.4%) and Walt Disney (+7.6%) did well while Microsoft (-14.4%) and Home Depot (-15.4%) were among the second quarter's biggest losers.

Among the eleven component sectors of the S&P 500, Utilities (+4.73%) and Energy (+3.85%) performed best during the second quarter while Information Technology (-9.78%) and Health Care (-5.39%) trailed. Year to date, Energy (+12.78%) and Telecom (+11.78%) have led while Information Technology (-6.17%) and Health Care (-4.57%) have lagged.

Because of the important role of the US in the world economy, fear of rising rates and inflation here also affected world markets. The MSCI-EAFE Index of developed markets

Chart 1

S&P 500, 12 Months: Is the Uptrend Still Intact?

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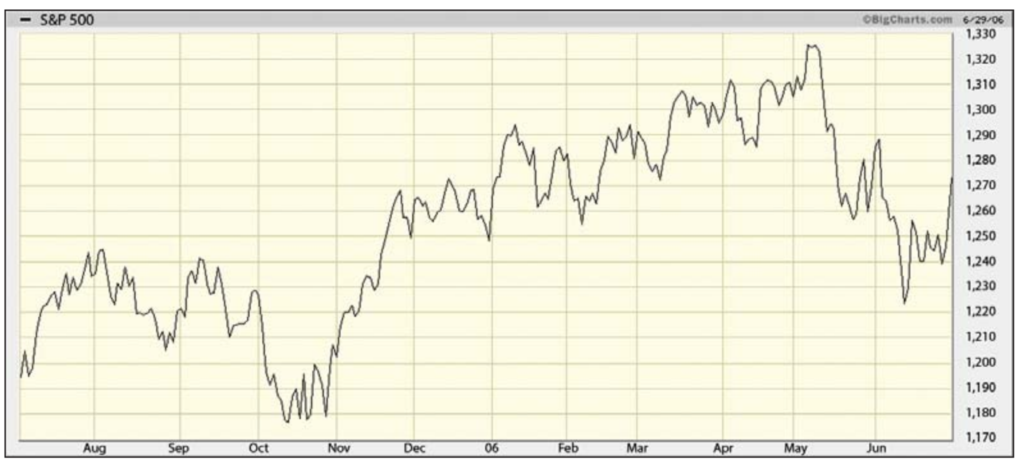

Chart 2

S&P 500 vs Russell 2000: Over Five Years, Small Caps Have Ruled

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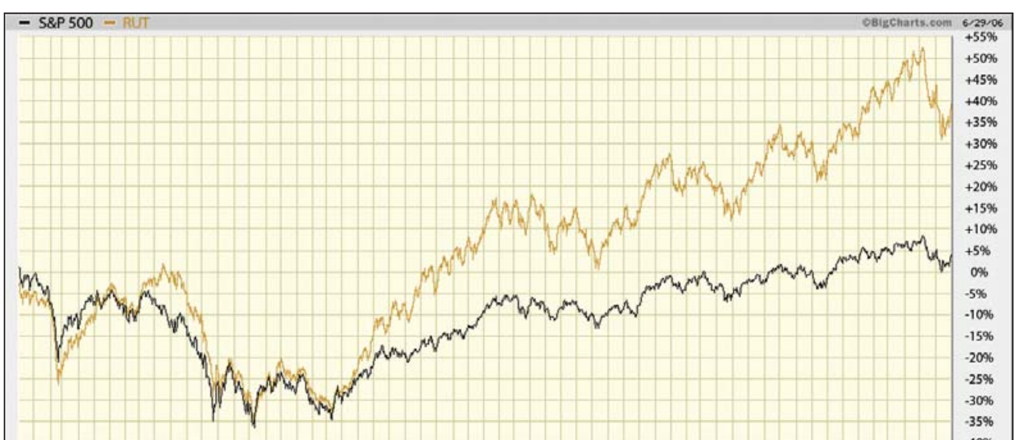

was up less than 1% for the quarter although still up over 10% for the year. Emerging markets, always the most volatile of all equity market sectors, were particularly hard hit. Nevertheless, even after many emerging market countries suffered double digit declines from highs reached earlier in the quarter, the overall 4.3% loss for the quarter (according to MSCI-EM) still left the sector with an overall year-to-date gain in excess of 7%. Thus, both developed and emerging markets have still outperformed US broad market indices during the first half of 2006.

The Bond Market

Difficulty in interpreting the intentions of the new Fed Chairman caused unusually high anxiety in the bond market. In April, Mr. Bernanke's congressional testimony led investors to believe that the rise in interest rates had run its course, but his remarks in May suggested just the opposite. Surprisingly, the Fed's statement after its seventeenth consecutive tightening in late June once again raised expectations that rates might stabilize.

The case for higher interest rates is inconclusive based on actual economic data—while the core CPI has inched up slightly, the all-important housing market is decidedly weaker. Nevertheless, the yield on the benchmark 10-year US Treasury note, which had been as low as 4.34% in January, rose to 5.145%, up from 4.857% at the end of the first quarter. The yield curve was unusually flat, as the 2-year note stood at 5.16% and the 30-year bond was at 5.19%. The performance of corporate bond and mortgage-backed bonds mirrored that of Treasuries, showing modest losses for the year. The Lehman Brothers Aggregate Index was down 0.08% for the quarter and off 0.7% for the year. High yield bonds managed to buck the trend and have generally registered modestly positive performance year-to-date.

Other Asset Classes

While the residential housing market has weakened throughout the country, commercial real estate has held up well. Accordingly, real estate continues to be a strongly performing, well-diversifying asset class. Despite a correction of about 2% during the second quarter, publicly traded real estate investment trusts are still up almost 13% for the year. Through the first quarter, private real estate investments continue to appreciate at an 18% annualized pace. Regionally, the east and the west appeared to be doing the best while, among sectors, there has not been much difference between office, apartments, hotels, industrial, and retail.

Activity increased somewhat in the Initial Public Offerings Market in terms of total volume and number of deals, but results have been mixed. Master Card, Inc., was the second quarter's largest issue and has performed well while internet phone company Vonage Holdings

Chart 3

S&P 500: Ten Year Perspective: Stocks Still Below Their 2000 Peak

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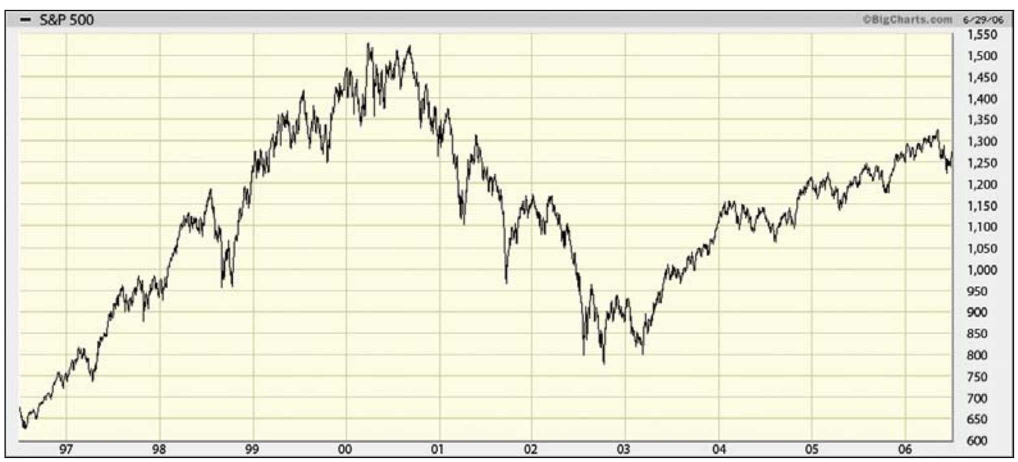

Chart 4

S&P 500 vs NASDAQ, Ten Years: Except for the Bubble, About Even

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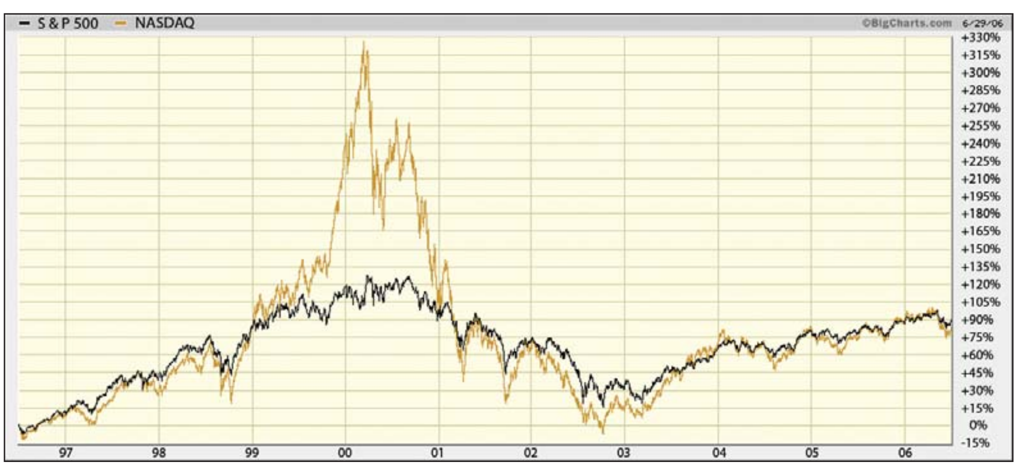

came to market but lost half its value through the end of June. Similarly, results for the entire private equity industry are likely to be mixed when they are announced.

For hedge funds, the biggest news occurred not in the markets but in a Washington, DC, federal appeals court, where the SEC's right to regulate the industry was thrown out on a legal technicality. The decision appeared to cause very little consternation, since many small hedge funds had complained about the costs of complying with the SEC requirements and many investors had little confidence in the agency's ability to effectively regulate hedge funds. Investment-wise, hedge funds have been having a year of steady but unspectacular performance, with composite returns of nearly every major strategy showing positive performance to date. Even convertible arbitrage, the one major strategy that floundered last year, has rebounded nicely in 2006. Databases of overall hedge fund performance indicate returns of between 3 and 4% for the first half of 2006.

In some respects, the second quarter may have been encouraging in that traditional investments like large cap stocks held up better than small caps and emerging market stocks, two areas that have done exceedingly well in recent years, during the market's recent period of volatility and re-valuation. These trends may well continue for a while, and with price/earnings ratios having declined considerably and the Fed possibly near the end of its tightening cycle, it's possible to construct an optimistic outlook for US stocks and bonds. Nevertheless, if history has shown us anything, it's that a portfolio well-diversified by asset classes and managed by top-tier investment managers will do well over time. For any system that may have questions about any aspect of its investment program, the PERAC Investment Unit would be pleased to offer any possible assistance.

TOTAL RETURNS | SECOND QUARTER, 2006

INDEX	SECOND QUARTER 2006	SIX MONTHS 2006
US EQUITY MARKET		
Dow Jones Industrial Avg.	+ 0.94%	+ 5.22%
Standard & Poor's 500 (Large Cap)	-1.44%	+ 2.71%
NASDAQ Composite	-7.20%	-1.50%
Wilshire 5000 (Broad Market)	-1.91%	+ 3.51%
Standard & Poor's Mid-Cap 400	-3.44%	+ 3.64%
Russell 2000 (Small Cap.)	-5.02%	+8.21%
GROWTH VS. VALUE		
Russell 1000 (Large Cap) Growth	-3.90%	-0.93%
Russell 1000 (Large Cap) Value	+ 0.59%	+ 6.56%
Russell Midcap Growth	-4.69%	+ 2.56%
Russell Midcap Value	-0.56%	+ 7.02%
Russell 2000 Growth	-7.25%	+ 6.07%
Russell 2000 Value	-2.70%	+ 10.44%
INTERNATIONAL EQUITY		
M.S.C.I. - E.A.F.E.	+ 0.70%	+ 10.16%
M.S.C.I. - Emerging Markets	-4.34%	+ 7.16%
FIXED INCOME		
Lehman Brothers Aggregate Index	- 0.08%	-0.72%
Merrill Lynch High Yield Index	+ 0.10%	+ 3.00%
REAL ESTATE		
NAREIT - Equity Real Estate Investment Trusts	-1.59%	+ 12.92%
NCREIF Property Index	+ 3.62%	+ 20.01%
	(Q1)	(Trailing 12 months)